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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 1138

RICHARD H. DUNNING and BEULAH MARIE DUNNING,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Richard H. Dunning and Beulah Marie Dunning pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above-entitled case on December 22, 1965.

CITATIONS TO OPINIONS BELOW

The opinion of the District Court, printed in Appendix B hereto, *infra*, p. A3, is reported at 232 F. Supp. 915 (W.D. Mo. 1964). The opinion of the Court of Appeals for the Eighth Circuit is as yet unreported and is printed in Appendix B hereto, *infra*, p. A27.

JURISDICTION

The judgment of the Court of Appeals (Appendix B, *infra*, p. A39) was entered on December 22, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether an accumulated deficit in the earnings and profits account of a corporation may be permitted to survive its reorganization in bankruptcy and to be recognized as offsetting earnings and profits realized by the successor corporation subsequent to such reorganization.

STATUTES INVOLVED

The statutory provisions involved are Section 112(b)(10), Internal Revenue Code of 1939, added by Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944); Section 316(a), Internal Revenue Code of 1954, ch. 736, 68A Stat. 98 (1954), 26 U.S.C.A. § 316(a), Section 371(a)(1), Internal Revenue Code of 1954, ch. 736, 68A Stat. 121 (1954), 26 U.S.C.A. § 371(a)(1). They are printed in Appendix A, *infra*, p. A1.

STATEMENT

Petitioners are shareholders of Missouri Public Service Company, a Missouri corporation (¶4, R. 8). In 1958, 1959 and 1960 they received distributions with respect to their stock which were reported in their federal income tax returns as taxable dividends and tax was paid thereon (¶¶ 5, 6, R. 9). Subsequently petitioners timely filed a claim for refund of income tax for each taxable year, and thereafter, when the claims were not allowed, filed suit in the District Court (¶8, R. 9). Because the suit arises under the internal revenue laws jurisdiction of the District Court was invoked under 28 U.S.C. Section 1346(a)(1).

In their claims for refund and before the courts below petitioners have asserted that the distributions to them in each taxable year were in part from sources other than the earnings and profits and that, to the extent they were from such other sources, the amounts thereof were not taxable as dividends but rather served to reduce the basis of the company's stock in the hands of petitioners. If petitioners are correct they are entitled to refunds. Respondent's position has been that all distributions to petitioners were from available earnings and profits, and are therefore 100% taxable as dividends, and that no refunds are due.

The District Court held for respondent and denied any refund. The Court of Appeals affirmed.

In each taxable year it is stipulated that distributions of the corporation exceeded its *current* earnings and profits (¶45, R. 22). It is petitioners' position that in each year the corporation had no *accumulated* earnings and profits which could have served as a source of distributions taxable as dividends.

The predecessor of the distributing corporation (which had the same name as the existing company) was organized as a Missouri corporation in 1926 (¶9, R. 9). It is stipulated that as of November 30, 1936, a deficit in earnings and profits had been accumulated amounting to at least $1,465,627.91 (¶39, R. 19).[1] Effective as of December 1, 1936, that corporation (hereinafter sometimes referred to as the "debtor") was reorganized under Section 77B of the Bankruptcy Act, ch. 424, § 1, 48 Stat. 912, as amended (¶24, R. 12). Thereafter, earnings and profits were realized by the corporation which succeeded to the assets and business of the debtor (¶40, R. 19). The successor corporation is to be identified with the corporation which made the distirbutions here considered (¶¶39, 40, 41, R. 19-20).

If, as contended by petitioners, the earnings deficit of the debtor carried through and is to be recognized after the 77B reorganization as offsetting the earnings and profits of its successor during the period subsequent to the 77B reorganization, the corporation making the distributions in question had no accumulated earnings and profits during the taxable years here involved.

Immediately prior to its reorganization, the debtor was (as to its common stock) a wholly owned subsidiary of Inland Power & Light Corporation (¶52, R. 24). At that time Inland was a wholly owned subsidiary of Commonwealth Light & Power Company (¶60, R. 26). Commonwealth, in turn, was a wholly owned subsidiary of Middle West Corporation (¶21, R. 11; ¶31, R. 16). The debtor, Inland, and Commonwealth were reorganized in consolidated proceedings under the jurisdiction of the District Court for the Northern District of Illinois (¶31, R.

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1. Petitioners contend that the deficit as of November 30, 1936, was $1,866,293.32 (R. 20).

16). Middle West was reorganized in bankruptcy in a separate proceeding before the same court (¶31, R. 16). Inland, Commonwealth and Middle West are for convenience referred to as the "parent" of the debtor corporation.

The capitalization of the debtor immediately prior to its reorganization consisted of secured bonds (principal amount $6,351,000) and voting preferred stock, both of which were held by the public, and common stock and approximately 1.3 million dollars of unsecured accounts and promissory notes, both the common stock and the accounts and notes being owned by the parent (R. 12-15, 24, 87, 154, 156). The preferred stock comprised 25% of the total voting stock (common and preferred combined) (R. 12). After the reorganization the capitalization of the successor corporation consisted of secured bonds (principal amount $4,445,700), common stock and common stock subscription warrants (R. 13).

The old secured bonds were exchanged for new secured bonds written down 30% in principal amount and the bondholders also received in the exchange 47.5% of the new common stock of the successor corporation (R. 13). The old voting preferred was exchanged for approximately 22.4% of the new common stock (R. 13-14) and the accounts and promissory notes were exchanged for approximately 30.1% of the new common stock (R. 14).

As a result of these exchanges those persons or entities which collectively held 100% of the prior equity interests in the debtor, i.e., the preferred stockholders with voting rights and the debtor's parent, collectively received 52.5% of the equity in the successor corporation. The balance of the common stock went to the bondholders.

The debtor's parent received, in addition to 30.1% of the new common stock, subscription warrants which would have enabled the parent, if the warrants had been exercised, to increase its holdings of common stock from 30.1% to more than 36% (R. 14, 16). The warrants were never exercised, however (probably because of the high exercise price), and expired by their own terms in the hands of the parent on December 31, 1939 (R. 16).

All the business and assets of the debtor were acquired and operated by the successor corporation, and all liabilities, including tax liabilities, excepting only the accounts and notes held by the parent (including accrued interest) and 30% of the old bond liability all of which were replaced by new common stock, carried over to the successor corporation (R. 11-12, 15). There was no investment of new capital, nor did any person or entity have an interest in the successor corporation which did not have an interest, as either creditor or shareholder, in the debtor (R. 12-15). A few changes in personnel occurred, but the business had essentially the same operating management both before and after the reorganization (R. 15-16, 159-171).

The District Court held that no portion of the earnings and profits deficit which was stipulated to exist as of November 30, 1936, could be carried over and recognized after the bankruptcy reorganization as offsetting the earnings of the successor corporation. The Court of Appeals affirmed.

REASONS FOR GRANTING THE WRIT

1. The question presented is of obvious importance in the administration of the federal bankruptcy and tax laws. Settlement of the question by this Court is plainly in the public interest since it is likely to be presented with

respect to corporate distributions to many thousands of taxpayers. Petitioners represent but one of approximately ten thousand shareholders of Missouri Public Service Company. More importantly, there are no doubt thousands of shareholders who have received or will receive distributions from other corporations which were, or whose predecessors were, participants in bankruptcy reorganizations. The status of those distributions will be subject to controversy until the question presented here is settled by this Court. Because the issue is the correct calculation of accumulated earnings and profits, the impact of the answer to the question presented is not limited to the taxable years here involved, but will or may affect distributions by similarly situated corporations for all future taxable years.

The Court of Appeals relied heavily upon its own earlier decision in *United States* v. *Kavanagh,* 308 F.2d 824 (8th Cir. 1962). Petitioners emphasized the decisions of the Tenth Circuit in *United States* v. *El Pomar Investment Company,* 330 F.2d 872 (10th Cir. 1964), and the First Circuit in *United States* v. *Snider,* 224 F.2d 165 (1st Cir. 1955).

While in the instant case the court stated (Appendix, *infra,* p. A38) that it is not laying down any "absolute rule" regarding bankruptcy reorganizations, the court also stated elsewhere in its opinion (Appendix, *infra,* p. A34) that "The *El Pomar* court distinguishes our *Kavanagh* case, pointing out that the reorganization before it was carried out voluntarily, whereas the *Kavanagh* reorganization took place in a 77B proceeding." Approval of that distinction by the court below makes the tax treatment of an earnings deficit turn on whether or not the transaction occurred in the course of a federal bankruptcy

proceeding as distinguished from other available statutory or non-statutory procedures. Petitioners do not believe that this is or should be the law.

To the extent that Congress has spoken at all in the revenue laws on the subject of insolvency reorganizations (exclusive of railroad reorganizations), its expressions are found in Section 112(b)(10) of the Internal Revenue Code of 1939 (enacted as a part of the Revenue Act of 1943, ch. 63, 58 Stat. 21 (1944)), and Section 371 of the Internal Revenue Code of 1954 (both statutory provisions cited are set out in pertinent part in the Appendix, *infra*, p. A1). Both sections accord the same tax-free treatment to a "receivership, foreclosure, or similar proceeding" as is accorded to a proceeding under Section 77B or Chapter X. Rather than insuring greater uniformity in tax consequences, as was intended by Congress, the view of the Court of Appeals will cause completely different consequences to flow from transactions which are essentially similar, with the result in each case being dependent upon whether or not advantage is taken of the federal bankruptcy act.

The view of the Court of Appeals penalizes corporations and their creditors and security holders who participate in bankruptcy reorganization. That result is not only illogical and unfair, but is unsupported by any provision of the bankruptcy or revenue acts and in fact is completely contrary to the intent of Congress in enacting the remedial provisions of Section 77B. This court has said, "The purpose of Section 77B was to facilitate rehabilitation of embarrassed corporations by a scaling or rearrangement of their obligations and shareholders' interests, thus avoiding a winding up, a sale of assets, and a distribution of the proceeds." *City Farmers Trust Co.* v. *Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294-295,

81 L. Ed. 324 (1937). Application of the view of the Court of Appeals would frustrate and defeat the remedial objectives of 77B by causing bondholders, creditors and participating shareholders to withhold the consents requisite to consummation of plans to preserve going business and thus would encourage the liquidation of businesses and the sale of their assets "on the block."

Petitioners believe that the survival or elimination of an earnings deficit is to be determined by reference solely to the capital and other changes which occur in a reorganization. Whether those changes occur in a bankruptcy proceeding or by some other means is irrelevant and this Court is urged so to hold.

2. If, as contended by petitioners, the fact that the reorganization here occurred in bankruptcy does not serve as sound or valid justification for the difference in results as between this case, on the one hand, and the *El Pomar* and *Snider* cases, *supra,* on the other, then an irreconcilable conflict exists between the Eighth Circuit and the Tenth and First Circuits.

The conflict between the Eighth and Tenth Circuits exists because the latter recognizes and applies the tests of continuity of ownership and continuity of business operations whereas the former does not.[2] In *El Pomar, supra,* these tests were held to have been satisfied and as a consequence an earnings deficit was held to survive two insolvency reorganizations.

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2. The tests are also widely recognized in reorganization and bankruptcy cases not involving earnings and profits. *Seiberling Rubber Co.* v. *Commissioner,* 169 F.2d 595 (6th Cir. 1948); *Western Massachusetts Theatres, Inc.* v. *Commissioner,* 236 F.2d 186 (1st Cir. 1956); *San Antonio Transit Co.* v. *Commissioner,* 30 T.C. 1215 (1958); *Atlas Oil Refining Corporation* v. *Commissioner,* 36 T.C. 675 (1961). These cases refine and develop the earlier continuity test referred to by the District Court, Appendix, *infra,* pp. A18-A19.

In the instant case there was simply a capitalization of debt into equity. No creditors were paid in cash. To the full extent that debt was reduced or extinguished there was but merely an exchange of debt for another type of continuing interest (common stock) in the debtor. Other liabilities, not exchanged for or replaced by common stock, were carried over and assumed by the successor corporation. No assets were sold or distributed or otherwise disposed of. Not one cent of new capital was invested. Substantial continuity of management was preserved. All shareholders of the debtor participated in the reorganization and became shareholders of the successor. The largest single shareholder of the debtor (i.e., its parent) was perpetuated in its dominant position. No person or group emerged from the reorganization having an interest in the corporation or its assets who did not have a prior interest either as creditor or stockholder. Here the tests of continuity of ownership and continuity of business operations were satisfied. The Tenth Circuit would permit the deficit carry-over.

Petitioners urge this Court to resolve the existing conflict.

3. Conflict exists also between the decision of the Court below and the decision of the First Circuit in *Snider, supra.* There a trust (taxable as a corporation) which owned and operated two hotels, reorganized itself into parent and subsidiary corporations each of which thereafter owned and operated one of the hotels. Stock of the parent was issued pro rata to the owners of the trust. It was held that an accumulated earnings deficit existing at the time of the reorganization was to be recognized as offsetting earnings and profits realized by the parent subsequent to the reorganization. The court so held because the reorganization had no tax avoidance purpose and the re-

sult of the carry-over was not to permit earnings and profits to escape dividend taxation which would have been so taxed had the reorganization not occurred.

In *Snider* the Court relied on *Commissioner* v. *Phipps*, 336 U.S. 410, 69 S. Ct. 616, 96 L. Ed. 771 (1949), wherein it was held that the deficits of five operating subsidiaries, following their liquidation, could not be subtracted from the parent's previously accumulated earnings and profits. In both *Snider* and *Phipps* the test applied was whether or not the fact of the reorganization itself or the manner in which it is structured creates the possibility or probability of tax avoidance. See also *Commissioner* v. *Sansome*, 60 F.2d 931 (2d Cir. 1932), *cert. den.* 287 U.S. 667, 53 S. Ct. 291, 77 L. Ed. 575 (1932). In *Phipps* that probability existed because the taxpayers sought to offset the deficit of one business against the already existent accumulated earnings of a different business. In the instant case as in *Snider*, however, the same business which had accumulated the deficit later realized the earnings, and the fact of the reorganization itself did not produce any possibility that earnings and profits could escape dividend taxation which would have been so taxable in the absence of the reorganization.

This Court is urged to determine whether it is the First Circuit or the Eighth Circuit by whom the proper test is being applied.

4. The Court below approved the theory (developed in the railroad reorganization cases cited by the Court, Appendix, *infra*, p. A35) that to permit the deficit carry-over would produce a "double benefit" in that the corporation escapes liability for its debts and the shareholders escape taxation by taking advantage of the former operating deficit. That argument is superficial and unsound for the following reasons:

1. It assumes that the shareholders, following the reorganization, will necessarily benefit from the opportunity to receive distributions out of capital. Such distributions, however, are not received "tax free" since they reduce the basis of shares upon which the distributions are made, thus increasing the taxable gain upon future distribution or corporate liquidation. Tax is not "escaped" but merely deferred.

2. When debt was reduced the bondholders and unsecured creditors of the debtor surrendered rights to receive approximately 3 1/4 million "tax free" dollars (in re payment of debt). The same persons received 77.6% of the new common stock carrying with it the mere possibility of receiving similar dollars if the deficit is carried over. The balance of the new common stock went to the holders of the old preferred who lost their preferred position. No second benefit is involved.

5. The Court of Appeals held that petitioners had failed to meet the "burden", purportedly imposed upon them, of overcoming a presumption that the distributions were from earnings and profits.

The Court, early in its opinion, quoted portions of Section 316 of the Internal Revenue Code of 1954 as follows:

> "* * * Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits * * *."

Apparently construing the quoted provision the Court stated (Appendix, *infra*, p. A30):

> "In order to escape dividend treatment as to the balance of the distributions, the burden is upon the taxpayers to show that the corporation had no accumulated earnings or profits from which the distribution could be made. * * * Taxpayers have failed to meet such burden."

That provision, however, does not create a true presumption, nor impose upon a taxpayer any corresponding burden, but rather states a rule of law. *Bazley* v. *Commissioner*, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782 (1947); 1 Merten's Law of Federal Income Taxation, Section 9.27, Rev. Ed. (1962). It assumes by its terms the existence of earnings and profits, either current or accumulated. Until the existence of earnings and profits is established, which is the entire issue in the instant case, the rule (or "conclusive" presumption) of the statute is never reached and, in fact, is quite irrelevant. Thus, the rule of the statute is irrelevant in the case of a distribution made at a time when there is stipulated to be an earnings deficit. The statute does not create any presumption that earnings and profits exist, but merely states that a distribution is deemed to be from earnings and profits if they do exist, and, if so, "to the extent thereof".

That a "burden" is imposed upon petitioners is emphasized again at the close of the Court's opinion (Appendix, *infra*, p. A38) as follows:

> "The taxpayers have failed to meet the burden imposed upon them to show that any loss of earnings account remained after the reorganization which could be carried over."

This view led not merely to a result believed to be erroneous but, more importantly, led the Court to a self-imposed limitation upon the scope of its own review of the decision of the District Court, thus effectively depriving petitioners of that measure of review at the appellate level to which they are entitled as a matter of law.

All the facts were stipulated and as so stipulated were found by the District Court. The evidence was entirely documentary and no question of veracity or credibility of wit-

nesses was involved. Neither the District Court nor the Court of Appeals held specifically that petitioners failed to meet the burden imposed upon them at the trial level of going forward with the evidence to the extent necessary to overcome the presumption of correctness initially attaching to a determination by the Commissioner of Internal Revenue, or that petitioners failed to affirmatively prove all facts necessary for a correct calculation of their tax liability. This is not a case in which motives or intent are relevant factors. Compare *Commissioner* v. *Duberstein,* 363 U.S. 278. 80 S. Ct. 1190, 4 L. Ed. 2d 1218 (1960). In contrast to *Kavanagh, supra,* this is not a case where the record is unclear or incomplete, or where it is necessary to draw "inferences", as suggested by both Courts below (Appendix B, *infra,* p. A18 and p. A32) to arrive at the controlling facts.

It was stipulated that as of November 30, 1936, the debtor corporation had a deficit in earnings and profits of at least $1,465,627.91. As of December 1, 1936, the changes in capital structure occurred which constituted the reorganization. The facts as to those changes were likewise stipulated. The question for decision then became whether the capital changes caused the deficit to disappear. The Court of Appeals treated the question as a "fact issue" (Appendix, *infra,* p. A35) as to which the burden was on petitioners. Merely calling the question one of fact does not make it so. *Elyria-Lorain Broadcasting Co.* v. *Lorain Journal Company,* 298 F.2d 356 (6th Cir. 1961). Petitioners assert that the issue was not one of fact at all, but rather was one of what consequences flowed as a matter of law from the capital changes. As to that question no presumption of correctness attaches to the decision of the District Court and there is no corresponding burden imposed

on petitioners before the Court of Appeals. *Copease Mfg. Co.* v. *American Photocopy Equipment Co.*, 298 F.2d 772 (7th Cir. 1961).

Before the Court of Appeals petitioners argued that the decision of the District Court was based on an erroneous view of the law. As to the law, petitioners were entitled to appellate review unrestricted by any presumption of correctness. They were denied that review. The interests of large numbers of taxpayers will be adversely affected if this Court leaves standing a construction of Section 316 which imposes upon taxpayers in a dividend case any heavier burden than normally exists in any tax case. At the Court of Appeals level all appellants will be penalized if this Court permits any presumption of correctness to attach to the views of a District Court as to matters of law.

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted

Respectfully submitted,

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